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SPECIAL REPORT

The Revenue and Distribution Impact of the President's Capital Gains Tax Proposal

To further a constructive dialogue on the revenue and distribution impact of President Bush's capital gains proposal, the ACCF Center for Policy Research presents a summary of recent testimony by Kenneth W. Gideon, assistant secretary of the Treasury for tax policy, and statements by Michael J. Boskin, chairman of the Council of Economic Advisers (CEA), and Under Secretary of the Treasury Robert R. Glauber. Both Treasury and the CEA conclude that the preponderance of academic and government studies suggest substantial revenue gains from lower capital gains tax rates.[1]

Details of the Bush Proposal

In general, the Bush administration proposed that the capital gains tax rate for individuals be reduced on long-term investments by enacting a sliding-scale exclusion for long-term capital gains. Under the proposal, assets held by individuals for three years or more would qualify for a 30 percent exclusion, assets held at least two years but less than three years would qualify for a 20 percent exclusion, and assets held at least one year but less than two years would qualify for a 10 percent exclusion. As a result of the exclusion, the tax rate applicable to capital gains on qualified assets held for at least three years would be 19.6 percent for taxpayers in the 28 percent tax bracket. Similarly, investments held by such taxpayers for between two and three years would be taxed at a 22.4 percent rate, and assets held for between one and two years would be taxed at a 25.2 percent rate. Individuals in the 15 percent tax bracket would pay proportionately lower rates of tax (13.5 percent, 12.5 percent, and 10.5 percent, respectively).

Qualified assets would generally be defined as any assets qualifying as capital assets under current law and satisfying the holding period requirements, except for collectibles. Collectibles are assets such as works of art, antiques, precious metals, gems, alcoholic beverages, and stamps and coins. Assets eligible for the exclusion would include, for example, corporate stock, manufacturing and farm equipment, a home, an apartment building, a stand of timber, or a family farm.

Differences in Revenue Estimates

The Treasury Department's Office of Tax Analysis (OTA) estimates that the President's capital gains proposal, if enacted, would increase revenues by $12.5 billion over the budget period and provide modest increases in revenue thereafter. The staff of the Joint Committee on Taxation (JCT) estimates that the proposal would lose $11.4 billion over the same period and continue to lose money thereafter. This represents a difference of $23.9 billion over the budget period.

According to the recent Treasury testimony, there are two major causes for the difference between the OTA and the JCT revenue estimates:

- The OTA assumes a smaller year-to-year change in capital gains realizations, absent any tax code revisions (the baseline forecast).
- The OTA assumes greater taxpayer responsiveness to capital gains tax rate changes (elasticity).

Baseline Forecasts. Table 1 summarizes the principal differences between the Treasury and the Joint Committee on Taxation estimates of the revenue impact of the Bush proposal. The static revenue loss is obtained by multiplying the change in the average tax rate on capital gains by the volume of realizations that would have occurred with no change in the law. The level of realizations that would have occurred with no change in the law is referred to as the "baseline" level of realizations. Differences in static revenue loss estimates can result from differences in baseline capital gains realizations and/or differences in the tax rates used. Table 1 shows that over the 1990-1995 period, the discrepancy in the two static revenue loss estimates is $15.7 billion. The OTA was not able to

[1]Statement of Kenneth W. Gideon, assistant secretary for tax policy, Department of the Treasury, before the Committee on Finance, U.S. Senate, March 6, 1990; and letters to key members of the congressional tax-writing committees from Michael J. Boskin, chairman, Council of Economic Advisers, and Robert R. Glauber, under secretary for finance, Department of the Treasury, March 6, 1990.

Table 1: Treasury and JCT Revenue Effects of the Administration's Capital Gains Proposal

Item		Fiscal Year ($ Billions)						
		1990	1991	1992	1993	1994	1995	1990–95
I. Static effect of 30% exclusion[1]	Treasury	–2.1	–14.3	–15.6	–16.6	–17.5	–18.4	–84.5
	JCT	–2.6	–17.7	–18.7	–19.9	–20.4	–20.9	–100.2
	Difference	0.5	3.4	3.1	3.3	2.9	2.5	15.7
II. Effects of induced realizations[2]	Treasury	2.8	19.3	18.4	17.0	16.6	17.0	91.1
	JCT	3.0	18.9	14.4	14.9	13.4	13.8	78.4
	Difference	–0.2	0.4	4.0	2.1	3.2	3.2	12.7
III. Effect of full depreciation recapture	Treasury	–0.0	–0.3	0.5	1.1	1.6	1.7	4.6
	JCT	0.3	1.8	1.9	2.1	2.1	2.2	10.3
	Difference	–0.3	–2.1	–1.4	–1.0	–0.5	–0.5	–5.7
IV. Effect of phase-in of the 3-year holding period	Treasury	—	–0.1	–1.0	–1.0	0.2	0.2	–1.7
	JCT	—	–0.3	–2.0	–0.9	0.4	1.6	–1.2
	Difference	—	0.2	1.0	–0.1	–0.2	–1.4	–0.5
V. Effect of treating excluded portions of gains as a preference item for AMT purposes	Treasury	—	–0.2	0.5	0.6	0.8	0.8	2.5
	JCT	—	0.1	0.1	0.2	0.2	0.2	0.8
	Difference	—	–0.3	0.4	0.4	0.6	0.6	1.7
VI. Effective date of proposal[3]	Treasury	–0.2	0.4	—	—	—	—	0.2
	JCT	0.1	0.6	—	—	—	—	0.7
	Difference	–0.3	–0.2	0.0	0.0	0.0	0.0	–0.5
VII. Total revenue effect of proposal	Treasury	0.5	4.9	2.8	1.2	1.7	1.4	12.5
	JCT	0.7	3.2	–4.3	–3.6	–4.3	–3.1	–11.4
	Difference	–0.2	1.7	7.1	4.8	6.0	4.5	23.9

Source: Department of the Treasury, Office of Tax Analysis, February 28, 1990.
Note: Details may not add to total due to rounding.
[1]This line reflects an estimate of the proposed exclusion assuming no change in taxpayer behavior.
[2]This line reflects an estimate of the increase in budget receipts attributable to taxpayer decisions to realize more capital gains as a result of the lower tax rate.
[3]Lines I-V, above, reflect a January 1, 1990, effective date; line VI represents an adjustment to these lines to reflect an assumed effective date of March 15, 1990.

separate the part of the JCT estimate due to the average tax rate and the portion due to the baseline estimate of capital gains realizations.

The OTA estimates that baseline capital gains realizations would increase gradually along with growth in the economy. The OTA believes that the JCT's baseline (which is provided to it by the CBO), in contrast, is assumed to jump by over 50 percent from 1988 (the last year for which data are available) to 1990. The OTA believes that the extraordinary increase in capital gains realizations projected by the CBO for this two-year period is highly improbable. Its effect is to raise the baseline level of realizations quite dramatically throughout the budget window, thereby significantly enlarging the JCT's estimates of the static revenue losses.

Taxpayer Responsiveness. Another major difference between the OTA and the JCT estimates, according to the Treasury testimony, is that the JCT estimate appears to assume a lower level of responsiveness (elasticity) by taxpayers, that is, less tendency to sell their assets in order to benefit from the lower capital gains tax rate.[2] The OTA concludes that there is a strong consensus that tax rates have significant effects on capital gains realizations. This result, according to Assistant Secretary Gideon, accords with intuition and simple common sense: lower rates induce more realizations and higher rates cause taxpayers to defer capital asset sales. The decision to realize a capital gain is generally highly discretionary and quite sensitive to the individual's tax environment. Even small differences in elasticities can have large consequences for revenue estimates—thus the concern about the elasticity value that is used.

[2]"Elasticity" is defined as the percentage increase in capital gains realizations divided by the percentage decrease in the overall capital gains tax rate.

The OTA's assumption about capital gains elasticities is based on a review of twelve government and academic studies that have examined the question. Three of these were published by the OTA in 1989. As CEA Chairman Boskin observes in his letter to members of the tax-writing committees on this subject, because the twelve studies use different methods and different data, they arrive at different estimates. While the Treasury and the JCT estimates are both within the range of effects implied by these studies, the Treasury estimate is much closer to the middle of the range: Only two of the twelve studies estimated taxpayer responsiveness as low as the JCT. While Treasury is closer to the average elasticity estimate, nine of the studies found an even greater response of asset sales to capital gains tax rates than did Treasury.

The CEA Chairman states that the three OTA studies released in 1989 by Treasury are the best available; however, it appears that they were not taken into account by the JCT. Each Treasury study employs a different technique and uses a different type of data, but they all arrive at similar conclusions. Each type of evidence has some problems, but the cumulative weight of the work is impressive, according to Chairman Boskin. The Treasury studies employ improved statistical techniques and more advanced modelling strategies than previous studies. For example, instead of choosing a single approach, the studies examine the sensitivity of the estimates to alternative specifications of the statistical model. Second, the studies recognize that individuals can reduce their tax rate through (legal) tax avoidance behavior. The analyses account for the fact that tax rates affect capital gains realizations *and* vice versa. Third, the Treasury studies recognize that there is a learning period after tax changes and permit a gradual adjustment of realizations to changes in the tax rate. Other studies assume that all changes occur immediately. Fourth, a wider range of economic behavior is examined than in previous studies. In particular, the studies analyze the interaction among different types of taxable income such as long-term gains, short-term gains, and ordinary income. Because individuals undertake comprehensive tax planning, this modelling approach produces more reliable estimates, according to CEA Chairman Boskin.

In his testimony, Assistant Secretary Gideon also points out that the elasticity estimates used by Treasury are smaller than those found in nearly all of the studies to date. The OTA assumes an elasticity of 1.2 in the short run, declining to about 0.8 in the long run. An implication of this elasticity is that the average marginal tax rate that would maximize revenues from the capital gains tax is about 23 percent. In other words, a rate either higher or lower than 23 percent would produce less revenue than a 23 percent rate.

While the implied revenue maximizing rate is a useful way to convey the concept of elasticity in a form that is more comprehensible to non-economists, the revenue maximizing rate is not ideal from the standpoint of economic efficiency and growth, according to Treasury. It is instead the upper limit at which tax should be imposed. While a higher tax rate always imposes efficiency losses on the economy by comparison to a lower rate, imposing tax at a rate above the revenue-maximizing rate would cause revenue loss as well.

The OTA's estimates of the latest administration capital gains tax proposal reflect a change in elasticity from that used in 1989 for the President's 15 percent capital gains proposal. Last year the OTA utilized a long-run elasticity of 0.9 rather than the 0.8 used this year. The OTA changed its elasticity in the normal process of updating its model and in an effort to be cautious. The direction of the change would, absent changes in the JCT's elasticities, have narrowed the gap between the two organization's estimates considerably.

Treasury analysis of the JCT estimates leads to the conclusion that the JCT's revenue-maximizing capital gains tax rate is around 35 percent. The implication of the JCT revenue-maximizing tax rate is that if the capital gains tax rate were raised to a level significantly higher than the current tax rates on ordinary income such as dividends and interest, total capital gains revenue would continue to increase. The OTA takes issue with this conclusion, stating that it is aware of no study suggesting that revenues would increase if the capital gains tax rate were significantly higher than the rate of tax on ordinary income. Virtually every study Treasury reviewed that allows computation of a revenue-maximizing rate implied that the maximizing rate is below the rate imposed on ordinary income. This is not surprising since, just as a portfolio effect is anticipated for a rate differential in favor of capital assets, taxpayers would be expected to attempt to shift out of capital assets if the rates imposed on them were higher than ordinary rates. The considered professional judgment of Treasury analysts and the CEA is that the JCT elasticity is simply too low, since it yields such a high revenue-maximizing rate.

Macroeconomic Impacts of Capital Gains Rate Cuts

Neither the OTA nor the JCT includes in its estimates macroeconomic, or "feedback," effects of lower capital gains taxes on economic growth and tax revenues. While this accords with the standard practice

Table 2: Distribution of Taxes on Capital Gains Under Current Law and the Fully Phased-in Administration Proposal

Permanent Adjusted Gross Income[2]	Tax on Capital Gains		Change in Taxes	
	Current Law	Rate Cut[1]	Static	Dynamic
Less than $10,000	0.3	0.3	0.0	0.1
$10,000 to $20,000	0.7	0.7	−0.1	0.1
$20,000 to $30,000	0.8	0.8	−0.1	0.0
$30,000 to $50,000	3.0	3.0	−0.5	0.0
$50,000 to $100,000	7.9	8.2	−1.1	0.3
$100,000 to $200,000	9.7	10.0	−1.4	0.3
$200,000 or more	26.8	27.7	−3.8	0.9
Total	49.0	50.7	−7.1	1.7

Source: Department of the Treasury, Office of Tax Analysis, March 5, 1990.
Note: Fully phased-in proposal at calendar year 1990 levels.
[1]This table is not directly comparable to revenue estimate tables because it shows the fully phased-in Administration proposal at estimated 1990 levels of realizations. The fully phased-in proposal provides 10, 20 and 30 percent exclusions for assets held one, two and three or more years, respectively.
[2]The income classifier for this table is estimated permanent Adjusted Gross Income for 1990 (including capital gains) imputed from a five-year panel of individual income tax returns.

of both staffs, it does not mean that such positive effects will not occur, merely that they are not estimated.

As CEA Chairman Boskin and Under Secretary Glauber note, although the impact of a capital gains tax cut on growth is difficult to measure precisely (and this is one reason that neither Treasury nor the JCT currently includes such formal estimates in its revenue projections), reasonable estimates yield revenue dividends which more than offset any static estimate of revenue loss. In their view, a conservative estimate is that the President's proposal would lower the cost of capital for business by 3.6 percent. The lower cost of capital will increase investment and, therefore, productivity and economic growth. Over the next five years, the lower cost of capital arising from the President's proposal can be reasonably expected to increase GNP by a total of $61 billion, according to the CEA, which would yield roughly $12 billion in added revenue. Even using the extremely pessimistic JCT estimates and making lower-bound assumptions, the capital gains tax cut would increase revenue over the next five years, once economic growth is considered.

Finally, Chairman Boskin and Under Secretary Glauber conclude that this is a conservative estimate of the likely beneficial effects of GNP, because a capital gains tax cut encourages the entrepreneurial, highly productive investments that contribute most strongly to growth. In addition, a capital gains tax cut will help "unlock" investors, allowing them to move to more productive investments. Estimates based only on the reduced cost of capital do not include these important effects on the mix of investment in the economy.

Distribution Effects of Lower Capital Gains Tax Rates

As Assistant Secretary Gideon observes in his testimony, enactment of the Bush proposal *increases* the tax burden of the wealthy. The OTA calculations demonstrate that once the dynamic responses of taxpayers are taken into account, the amount of taxes paid by high-income taxpayers will increase (see Table 2). Taxpayers with incomes of $200,000 or more will pay almost one billion dollars in additional capital gains taxes. The share of taxes paid by lower- and middle-income taxpayers will decline since their taxes do not increase so significantly.

For purposes of comparison, Table 2 also shows how taxes paid would change without taking behavioral changes into account. The distribution of changes in capital gains taxes under the "no behavioral change" assumption appears to show that high-income taxpayers would receive large tax reductions. Dynamic distribution analysis, however, clearly indicates that these high-income taxpayers would pay more in taxes.

Thus, dynamic analysis shows that a capital gains tax cut provides a "win-win" situation: While high-income taxpayers would pay more in taxes, they would be better off because the lower capital gains tax rates will allow them to make investment decisions with less concern about the tax impact. They will have chosen to pay the additional taxes voluntarily. Taxpayers with lower incomes will not pay more unless they also benefit from the rate cut. Overall, the result is to collect relatively more taxes from those with higher incomes.

It should also be pointed out that in Table 2, taxpayers are classified according to their average income over a period of years, which is referred to as "permanent income." This contrasts with a single-year measure of income that includes capital gains, which fails to classify many taxpayers in the correct income class. In particular, the use of single-year income including gains classifies many middle-income taxpayers with large one-time gains from the sale of a small business, a farm or a personal residence as "high-income." As a result, the share of capital gains attributed to high-income taxpayers is overstated. In

contrast, the OTA analysis shown in Table 2 classifies taxpayers by income other than capital gains. By averaging a taxpayer's income over five years, the effects of temporary income spikes are substantially reduced and overcorrection is also avoided.

The JCT's estimate of the distributional effect of lower capital gains rates, according to the OTA testimony, is based solely on the static portion of its estimate. In other words, the JCT ignores the dynamic part of its own estimate. The JCT estimate is therefore a distribution of the benefits of a rate cut to those who would have sold capital assets in any event, but it ignores distribution of the additional tax paid by those who will be induced to sell at lower rates. Table 2 provides a more complete and accurate picture than does the JCT analysis, according to Assistant Secretary Gideon.

Conclusions

Treasury and the CEA conclude that the Treasury estimates are superior to those of the JCT and that the Treasury estimates probably understate the increase in revenue that would result from a cut in the capital gains tax rate. They stress that the best professional evidence is that the increase in revenue arising from lowering the capital gains tax rate will be substantial. Their analyses support the view that the President's capital gains tax proposal represents an opportunity to encourage investment and innovation, create jobs, and promote American competitiveness.

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